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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 193

WHITE BROTHERS COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 70-77) is not officially reported. The opinion of the Court of Appeals (R. 90-93) is reported at 180 F. 2d 451.

JURISDICTION

The judgment of the Court of Appeals was entered on March 9, 1950. (R. 94.) A petition for a rehearing was filed on March 30, 1950 (R. 95-98), and was denied on April 10, 1950 (R. 99). The peti-

tion for a writ of certiorari was filed on July 10, 1950. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The taxpayer, for income tax purposes, has consistently reported its income from installment sales on the installment basis. In years prior to the excess profits tax years, the taxpayer made distributions to its stockholders at times when, computed on the installment basis, it had a deficit in earnings and profits. During the excess profits tax years it elected, under Section 736(a) of the Internal Revenue Code, to report income from installment sales on the accrual basis for purposes of the excess profits tax only.

Section 718(b)(1) of the Internal Revenue Code provides that equity invested capital, one of the basic credits in computing the excess profits tax, is to be reduced by the amount of prior distributions which were not out of earnings and profits.

The question is whether, as the courts below held, the taxpayer's earnings and profits account in these prior years is to be computed on the installment basis, thus requiring a reduction in equity invested capital because the distributions would not have been out of earnings and profits, or whether, as the taxpayer contends, it is entitled to recompute its earnings and profits for prior years on the accrual basis, which would result in a surplus from which the distributions would have been paid and, conse-

quently, no reduction in equity invested capital under Section 718(b)(1).

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are set forth in the Appendix, *infra*, pp. 14-25.

STATEMENT

The facts in this case were stipulated (R. 38-43), and were found by the Tax Court as stipulated (R. 71-74). Those which are pertinent to the present issue may be summarized as follows:

The taxpayer is a Louisiana corporation with its principal office at New Orleans. Prior to 1920, the taxpayer kept its books and filed its income tax returns on the accrual basis of accounting. In 1920, it elected to report its income from installment sales on the installment basis and has done so ever since. It reported its income for income tax purposes in 1943 and 1944 on the installment sales method, but, in accordance with an election under Section 736(a) of the Internal Revenue Code, it reported its income from installment sales on the accrual basis for excess profits tax purposes. (R. 38.)

In its original excess profits tax returns for the years 1943 and 1944, the taxpayer claimed an excess profits tax credit based on average earnings. Subsequently, it filed claims for refund for those years claiming, without objection by the Commissioner, an excess profits tax credit based on invested capital. The taxpayer and the Commissioner agreed

that $284,706.75 was paid into the taxpayer-corporation as invested capital. (R. 39-40).

The Commissioner, however, reduced the taxpayer's invested capital, pursuant to Section 718 (b)(1) of the Code, by the amount of $104,105.80, on the ground that this was the amount of prior distributions made by the taxpayer which were not out of its accumulated earnings and profits. (R. 40.)

The distributions in question were paid in the calendar years 1921-1924, inclusive, and in the calendar year 1929 in the following amounts (R. 41):

Year	Amount
1921	$22,636.11
1922	24,756.60
1923	19,493.99
1924	27,888.79
1929	9,330.31
Total	$104,105.80

It was stipulated that these distributions were not out of accumulated earnings and profits if the earnings and profits account is computed on the installment basis with respect to installment sales. It was also stipulated that there would have been sufficient earnings and profits for these distributions if, during those years, the earnings and profits account should be computed by accruing profits from installment sales. (R. 41.)

The Tax Court and the Court of Appeals upheld the Commissioner's contention that the earnings

and profits accounts during those years could not include accrued profits on installment sales and that, accordingly, these distributions were not out of earnings and profits, and that Section 718(b)(1) required a reduction in equity invested capital.

ARGUMENT

The issue presented by this case concerns the method of accounting which should be used to ascertain the amount of the taxpayer's accumulated earnings and profits account in each year during 1921-1924, and 1929, when it made certain distributions to its stockholders. (R. 41.) It arises under the provisions of Section 718(b)(1), Internal Revenue Code (Appendix, *infra*, p. 18), which provides that equity invested capital (available as a credit in computing the now repealed excess profits tax) should be reduced by the amount of distributions made by a taxpayer in prior years "which were not out of accumulated earnings and profits."

During the time that the distributions in question were made, and ever since, the taxpayer has, for income tax purposes, consistently reported its net income from installment sales on the installment basis. (R. 38.) That is, an income tax was paid only on the profit attributable to installment payments actually collected during a particular taxable year. It is conceded that, if the taxpayer's earnings and profits account during those years should be computed by the same accounting method used for income tax purposes, thereby excluding profits not

yet realized from installment sales, there was a deficit in earnings and profits, so that the distributions in question were not made out of accumulated earnings and profits. (R. 40-41.) If that is the correct method of computing earnings and profits, as the courts below held, there is no question that equity invested capital is required to be reduced under Section 718(b)(1) in the amount determined by the Commissioner.

The taxpayer contends, however, that since it made an election under Section 736(a) of the Code (Appendix, *infra,* pp. 18-20) to compute its income from installment sales on the accrual method of accounting for purposes of the excess profits tax, it is entitled to recompute its accumulated earnings and profits during the years 1921-1924, and 1929, on that basis instead of on the installment basis. It is stipulated that the distributions in question would have been made out of accumulated earnings and profits if the accrual method were proper, *i.e.,* if earnings and profits during those years should include profits not yet realized from installment sales.

1. There are several reasons why the taxpayer's contentions lack merit, and why the decision below is correct. *First*—Section 115(l), Internal Revenue Code (Appendix, *infra,* pp. 16-17), specifies how earnings and profits are affected by gains and losses. Accumulated earnings and profits are increased only to the extent that realized gain from a

sale of property by a corporation "was recognized in computing net income under the law applicable to the year in which such sale" was made. The principle embodied in statutory language by Section 115 (l) was always the determinative rule for computing earnings and profits. *Commissioner* v. *Wheeler,* 324 U. S. 542; *Commissioner* v. *South Texas Co.,* 333 U. S. 496. Here, under the law applicable during the period in controversy (1921-1924, 1929) and under the accounting method always employed by the taxpayer, the uncollected profits from installment sales were not yet recognized in computing net income and could not have had any effect, for tax purposes, on the taxpayer's earnings and profits account. Such was the decision in *Commissioner* v. *South Texas Co., supra.* There could, of course, have been no possible basis for computing earnings and profits on the accrual basis, while reporting income on the installment basis, for, otherwise, earnings and profits would have been augmented prior to the time that profits from the installment sales were recognized in computing net income, contrary to the rule applied in the *Wheeler* and *South Texas* cases and as set forth in Section 115(l).

Second—there is nothing in Section 736(a), and the election exercised by the taxpayer to compute income from installment sales on the accrual basis for excess tax purposes, which would make the election applicable to sales and collections made prior to the excess profits tax years or which would alter the status of its earnings and profits account in such

prior years. Accordingly, this case is not distinguishable from *Commissioner* v. *South Texas Co., supra,* even though that case did not involve an election under Section 736(a). That section limits the use of the accrual basis to computing "income" from installment sales; it makes no provision for its use in computing earnings and profits. Moreover, that section, in providing that adjustment on the accrual basis should be made for income in prior excess profits tax years, limits the adjustment to taxable years "beginning after December 31, 1939" (*infra,* pp. 19-20). It grants no authority to make any kind of adjustment for any purpose for any prior year. Accordingly, while there is disagreement whether the election under 736(a) has an effect on earnings and profits with respect to sales accruing during the excess profits tax years,[1] the deci-

[1] Section 35.736 (a)-2, Treasury Regulations 112, promulgated under the Internal Revenue Code, expressly provides that the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from an election under Section 736 (a) of the Code. These Regulations have been held invalid with respect to installment sales accruing during excess profits tax years, the decisions holding that accumulated earnings and profits at the beginning of the taxable year, includible in equity invested capital under Section 718 (a)(4), Internal Revenue Code, are increased by profits from installment sales which accrued during the preceding excess profits tax year. *Kimbrell's Home Furnish.* v. *Commissioner,* 159 F. 2d 608 (C.A. 4th); *Busch's Kredit Jewelry Co.* v. *Commissioner,* 179 F. 2d 298 (C.A. 2), certiorari denied, 339 U.S. 967; *John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C.A. 9), certiorari denied on the Commissioner's petition on this issue, 339 U.S. 967.

These decisions are limited to installment profits accruing during the excess profits tax years and have nothing to do with sales made prior to that time. As indicated above, the *Breuner* case held that there could be no accrual of earnings

sions have been uniform that, notwithstanding the election under Section 736(a), earnings and profits are not affected where sales antedate the excess profits tax years, even though collections have not yet been made. *May, Stern & Co.* v. *Commissioner,* 181 F. 2d 407 (C.A. 3), pending on the taxpayer's petition for a writ of certiorari, No. 91, October term, 1950; *John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C.A. 9), certiorari denied on the Commissioner's petition on other phases of the case, 339 U. S. 967. In the present case, where both sales and collections were made before the excess profits tax years, it is even clearer that earnings and profits could not have been augmented prior to the years when the collections were made.

Third—even those decisions which have held that earnings and profits were augmented by profits from installment sales which were accrued during the excess profits tax years, are in accord with the result below (see fn. 1, *supra,* pp. 8-9). That is, the courts there reasoned that, since the uncollected profits had been subjected to tax under the excess profits tax because of the accrual method of accounting elected under Section 736(a), those profits ought to enter into accumulated earnings and profits at that time, even though they had not yet been recognized for purposes of the income tax.

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and profits with respect to sales made prior to the excess profits tax years, and such, too, was the holding in the *May, Stern & Co.* case, *supra.* These rulings are in accord with the decision below.

Here, however, the uncollected installment profits had not been subjected to any kind of tax in the years when the distributions were made and there would be no possible reason for including them in earnings and profits at that time. The reasoning of these courts, accordingly, would indicate that they would reach a result in accord with the decision below if a similar case were to arise. Compare the *Breuner* case, *supra,* on the issue relating to installment sales in pre-excess profits tax years and the similar decision in the *May, Stern & Co.* case, *supra.* See the Commissioner's Brief in Opposition in *May, Stern & Co.* No. 91, this Term, pp. 7-8.

Fourth—Section 718(a) (Appendix, *infra*, pp. 17-18) requires that there be included in equity invested capital the capital contributions actually made by the stockholders, either by way of original capital contributions or by way of subsequent profits permitted to remain in the business. Section 718 (b) requires that equity invested capital be reduced by the amount of capital withdrawn by the stockholders from the business. We believe that a reduction in equity invested capital under Section 718(b)(1), because of prior corporate distributions not made out of earnings and profits, plainly has reference to distributions which were not taxable as dividends to the stockholders because they were a return of capital,[2] just as Section 718(a)(3) re-

[2] The distinction between a distribution which is taxable as a dividend to the stockholders and one which is a return of capital always turns on whether the distribution is out of earnings and profits. Section 115, Internal Revenue Code.

quires that equity invested capital be increased by profits which were capitalized in the form of taxable dividends.

Whether the distributions here were out of accumulated earnings and profits and, hence, were taxable as dividends to the stockholders in the years when received by them, or whether they were not taxable as dividends because there were no earnings and profits and, hence, constituted a return of capital to the stockholders, must be determined by the method of accounting used by the corporation in computing its net income in the years when the distributions were made. Section 115(l), Internal Revenue Code; *Commissioner* v. *Wheeler,* 324 U. S. 542. Under any view of the situation, there was no possible basis for taxing the distributions as dividends in the years when they were made and, quite plainly, their taxable effect to the stockholders in 1921-1924, and 1929, could not be altered by a method of accounting elected by the corporation many years later for excess profits tax purposes.[3] Cf. *Commissioner* v. *South Texas Co.,* 333 U. S. 496. Since the distributions constituted returns of capital to the stockholders in these prior years, that is the precise reason why Section 718

[3] If the taxpayer be understood to contend (Pet. 4) that the distributions here were taxable as dividends to the stockholders, the contention is plainly wrong. The record is silent whether the stockholders treated the distribution as dividends. However, under the stipulated facts, it is clear that the distributions could not have been properly taxed to the stockholders as dividends since no earnings and profits were then available.

(b)(1) requires that equity invested capital should be reduced.

2. There are no conflicting decisions on the issue of this case, namely, the proper method of accounting to determine earnings and profits and the nature of corporate distributions in years prior to the effective date of the excess profits tax law. The decisions relied on by the taxpayer (Pet. 6-7) are not in conflict for the reasons already set forth, pp. 6-11, *supra*. Indeed, as we have shown, on a related issue, the Courts of Appeals agree that installment sales made prior to 1940 (i.e., prior to the excess profits tax) enter into earnings and profits on the installment method of accounting, without regard to the accrual method elected under Section 736(a). *May, Stern & Co.* v. *Commissioner,* 181 F. 2d 407 (C.A. 3), pending on the taxpayer's petition for a writ of certiorari, No. 91, October Term, 1950; *John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C.A. 9), certiorari denied on the Commissioner's petition on the other phases of the case, 339 U. S. 967.

3. The denial of certiorari on May 29, 1950, of the Government's petitions for writs of certiorari in *Commissioner* v. *Busch's Kredit Jewelry Co.,* 179 F. 2d 298 (C.A. 2), 339 U. S. 967, and in *Commissioner* v. *John Breuner Co., supra,* 339 U. S. 967, which involved different, but more important, issues concerning installment basis taxpayers who had elected the accrual method of accounting for excess profits tax purposes, and where applicable

Treasury Regulations held invalid, suggests an additional reason why the petition here ought to be denied. See Commissioner's Brief in Opposition in *Mar[illegible] v. Commissioner,* No. 91, this Term.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST 1950

APPENDIX

Internal Revenue Code:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personalty.*—In the case of (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property

other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U.S.C. 1946 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment represent-

ing gain or profit in the year in which such payment is received.

(26 U.S.C. 1946 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(26 U.S.C. 1946 ed., Sec. 112.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(l) [as added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other

disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

SEC. 718. [added by Section 201 of the Second Revenue Act of 1940, *supra.*] EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be deter-

mined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in Previous Years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits; * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 718.)

SEC. 728 [as added by Section 201 of the Second Revenue Act of 1940, *supra*]. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U.S.C. 1946 ed., Sec. 728.)

SEC. 736 [as added by Section 222(d) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by

section 44(a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44(a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44(a). Except as hereinafter provided such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after

December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44(c).

* * * * *

(26 U.S.C. 1946 ed., Sec. 736.)

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

* * * * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be

applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was therefore determined by, the Board of Tax Appeals, or any court of the United States.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while more bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment

transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

* * * Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). * * *

* * * * *

SEC. 29.115-12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115(l) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the

earnings and profits for any period beginning after February 28, 1913. * * *

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24(b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed non-recognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) as distinguished from the realized gain or loss used in computing net income.

The application of this paragraph may be illustrated by the following examples: * * *

* * * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In General.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. * * *

SEC. 35.718-6. *Determination of Daily Equity Invested Capital.—Reduction by Earnings and Profits of Another Corporation.*—Section 718(b)(3) provides for the elimination of the duplication which occurs in the computation of the equity invested capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer. The earnings and profits of such other corporation having been included at the time of the transaction in the earnings and profits of the taxpayer, they remain continuously thereafter a

part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718(a)(4) relating to accumulated earnings and profits as of the beginning of the taxable year. * * *

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